Minutes of the meeting held on June 11, 2014

Present: Francis Murphy - Chair, Jim Monagle, Michael Gardner, Ellen Philbin, Louis Depasquale, Rafik Ghazarian, and Chris Burns.

The meeting was called to order at 8:43 AM. The meeting was digitally recorded.

Agenda Item # 1 – Manager Reviews
Ghazarian reviewed a written analysis of investment performance for the period ending March 31, 2014. The portfolio remains somewhat overallocated to the present target for equities, and underallocated to real estate and alternatives. Segal is not presently making any recommendation on rebalancing until the system makes a decision on the asset allocation model.
Overall, the Total Fund was valued at $1.052 billion, representing a gain of 1.82% during the quarter. The fund underperformed with the policy index return of 2.03%.
Ghazarian noted changes to the quarterly report, which now compares each segment of the portfolio to a broader index fund. In the domestic equity segment, six individual managers posted a combined return of 1.61% over the last quarter vs. the Russell 3000 at 1.97%.
Ghazarain reviewed the performance of Fred Alger. He stated that the Board has already opted to terminate this manager, but has not yet funded their replacement, the index fund managed by Rhumbline. Fred Alger has continued to manage the account during the transition. Over the last three quarters, their performance has improved significantly, and they are now running slightly ahead of their benchmark since inception.
The Chairman requested that Segal add a page to their report, showing the returns of the various benchmarks that the active managers are measured against.
In the domestic fixed income sleeve, the overall portfolio returned 2.55% in the last quarter, vs. the index at 1.84%. Gardner stated that he has been concerned with the performance of MacKay Shields, as they are now below their benchmark across most time periods. Ghazarian also noted that there have been changes in the management team at MacKay. Segal plans to meet with the new managers and to evaluate their strength going forward.
Ghazarian reviewed an analysis showing the system's performance vs. the PRIT core fund. Cambridge has performed significantly better than PRIT since 2008. The most significant outperformance was in 2013, and the greatest underperformance was in 2004 and 2005. Ghazarian stated that the recent outperformance was most likely due to the overallocation to equities, vs. PRIT, which has allocated more funds to alternatives. Over the last five years, Cambridge has paid slightly lower fees than the PRIT fund, having cut back the fees paid to traditional asset managers by about 10 basis points since 2004.
Ghazarian reviewed the educational materials prepared by Segal regarding Infrastructure and Emerging Markets Debt. Segal recommends that their clients avoid "greenfield" investing, which involves the development of new infrastructure assets, as it entails significantly more risk than buying established assets. Investing would be done similarly to a private equity fund, with the Board committing an amount to be drawn down as the fund makes investments. Ghazarian stated that several of his union clients have made infrastructure investments, and that they have shown good returns. Gardner requested that Ghazarian provide information on the specific funds that Segal has worked with in the past, showing their returns, and the types of investments these funds made.
Within the Emerging Markets Debt class, Ghazarian noted that the primary reason to invest is that such funds generally offer higher returns than other fixed income classes, and have low correlation with US Treasuries. The funds invest primarily in sovereign debt, though there may also be some portion invested in corporate debt. He stated that an Infrastructure fund would likely be a closed-ended account, but that an Emerging Markets Debt fund would be open-ended, and subject to periodic reviews under Chapter 176.

Ghazarian stated that it may be possible to find an Infrastructure fund that invests some portion of their portfolio in farmland, but that he would not recommend that the system invest in a fund that buys exclusively farmland.

Kevin Collins and Tyler Foster represented Fred Alger Management. A written overview of the portfolio was presented to the Board. Foster stated that he was aware that the Board was unhappy with the performance in the account, and had voted to move the account to a passive manager. He stated that the underperformance was primarily attributable to a period in 2010 and 2011. Collins noted that during this period, there was significant Fed intervention in the capital markets which resulted in a great deal of new money entering the markets, and pushed prices up, regardless of the fundamentals of the individual stocks. He also stated that the portfolio does have a positive return since inception, and is now slightly ahead of the benchmark. Collins stated that he was optimistic about the future outlook, as the US economy continues to grow, without significant Fed intervention. Foster stated that he would be happy to discuss options in order to retain the account, including renegotiating the current management fee.

Richard Wells represented Wedge Capital Management. A written review of the portfolio was presented to the Board. There have been no changes to the portfolio management or strategy. The total assets under management in the midcap portfolio is now $3 billion. Wells stated that the firm would not consider closing the account before reaching $5 billion. Wedge has maintained a lower price-to-earnings ratio than the index, and also has a higher dividend yield. The sector weightings are largely similar to the index, although with an overweight to capital goods, and an underweight to financials. The portfolio has maintained the capital goods overweight since 2009, and Wells stated this has been a major driver of returns, as the economy continues to show steady growth. Gardner requested that Wells provide additional information on the firm’s cash holdings, and the level of cash drag on the portfolio. Wells stated that the firm tries to hold under 3% in cash. Wells stated that he was comfortable with current valuations in the equity markets, and did not feel that the markets were entering a period of froth.

Richard D’Auteuil and Kenneth Hedgebeth represented Columbia Management. A written review of the portfolio was presented to the Board. Over the last year, the fund has outperformed the benchmark, although it remains slightly below the benchmark, on a net-of-fees basis, over the last three years. D’Auteuil reviewed the composition of the portfolio, noting that Columbia has a lower average market cap than the Russell 2000. Columbia prefers to invest a portion of the portfolio in the “micro-cap” space, which tends to be less volatile than the small cap space. He also discussed the firm’s decision to avoid biotech stocks. He noted that these companies can spend years in a R&D phase with no earnings, and that he feels they are too risky. D’Auteuil also discussed their process when a holding is acquired, or merges with another firm. In most instances, one of their holdings is bought up by a larger company, and then ceases to be a small-cap stock. In this case, the holding is always liquidated. In cases where two small-cap firms merge, and remain in the small-cap space, Columbia will evaluate the new firm on a case-by-case basis. The Director confirmed that Cambridge is still involved in litigation involving National Interstate Insurance, and that Columbia should continue to hold that company’s shares.

Bernard Horn, Ashley Hyotte and Gerald Cosgrove represented RBC Global Asset Management. A written overview of the portfolio was presented to the Board. There have been no changes to the portfolio management in the last year. One new analyst was hired and Horn also stated that his daughter has begun working at the firm. Horn described changes to the firm’s screening process, noting that they are now able to evaluate significantly more firms than were available in the past. He stated that in the last twelve years, the number of firms in their database has increased from 15,000 to about 35,000. This includes newly formed firms, in addition to firms in countries that have recently shifted to a market economy. Fund returns in 2013 were very strong, outperforming the benchmark by over 800 basis points, and ranking in the top 1% of the fund universe. Horn described the companies that were significant contributors to performance, including Greencore, an Irish food packager which is now expanding its US operations. Detractors from performance included Samsung, which experienced slower-than-expected phone sales. The portfolio remains underweight in Japan, although Horn stated that he is now screening a large number of small and mid-cap Japanese firms. He noted that Japanese stocks have performed well over the last year, and that he anticipates making new investments there over the next year. He also stated that he anticipates making new investments in the Financials sector.

Nate Hudson and Kirk Kashevaroff represented MacKay Shields. A written overview of the portfolio was presented to the Board. Kashevaroff stated that Matt Philo, head of the High Yield team, resigned for personal reasons. The resignation was unexpected. He will remain with the firm in a limited capacity through the end of the year. Hudson stated that the sectors covered by Philo have been reassigned and that there have been no changes to the overall strategy of the portfolio. Hudson reviewed MacKay's investment process and risk analysis. He noted that after reviewing the risk, MacKay sorts their portfolio into four risk classes. These classes often, but not always, correspond to their bond rating, and the firm works to try to find a mismatch which would allow a bond to be purchased at a discount. Gardner noted that he was concerned that the firm appears to have performed well between 1998 and 2002, but has underperformed the benchmark over the last twelve years, and has also been below median within the high yield universe. Hudson attributed this to the decision to largely avoid the CCC segment of the market, as most of these bonds do not meet MacKay's risk standards, although the CCC segment has performed very well, and driven high returns in the index. Kashevaroff stated that MacKay's default rate is half that of the index. He also noted that the strategy was successful in 2011, when the CCC segment of the index experienced losses which MacKay was able to avoid. Hudson stated that, over the last five years, their strategy to manage risk and avoid defaults has not been sufficient to beat their index. He stated that this is attributable to the Fed's manipulation of the markets, which created an environment in which companies which should have defaulted were able to remain solvent. He also stated that the portfolio has historically underperformed during periods where the equity markets show strong returns.

Frank Sposato represented Lazard Asset Management. A written review of the portfolio was presented to the Board. There have no changes to the strategy or management team. Sposato stated that the last four months have been very good for the emerging markets space, after a period of 18 months when they were largely flat. Sposato noted that this has been aided by lessened tensions in Russia, as well as investors adjusting to the reality of slower growth in China. He stated that Lazard sees such periods as a buying opportunity, which he now hoped was beginning to result in strong returns. Sposato reviewed the firm's research process, noting that analysts cover specific industries, and frequently travel to review the companies in the portfolio. The Chairman requested that Sposato send reports showing the portfolio returns as of May 31, 2014. Sposato stated that historically, emerging markets has been a volatile investment sleeve, although he felt that it was less volatile now than in prior years. He stated that he felt that the Emerging Markets space appears to be more vulnerable to bad news, even when the news has no material effect, in that investors appear to have a tendency to withdraw from emerging markets accounts first. He also stated that this perceived risk premium drives some of the higher returns from emerging markets debt. He also stated that in emerging markets, many of the debt securities are held by citizens of that country, which gives a strong incentive to the government to avoid default.

Ghazarian reviewed the performance of MacKay Shields, noting that they do show much stronger returns during periods when the equity markets are down. Seagl's analysis shows that

MacKay tends to capture 85% of gains during up markets, but only experiences 63% of losses during down markets. He also stated that it would be difficult and expensive to attempt to replicate the Credit Suisse High Yield index.

Ghazarian reviewed the proposed asset allocation models, and stated that he would recommend adoption of model #5, which adds both Emerging Markets Debt and Infrastructure investments to the portfolio. Gardner stated that he has reviewed the allocation model adopted by PRIT, which claims a Sharpe ratio of .46. Segal's proposed model has a Sharpe ratio of .38. Ghazarian stated that the ratio measures the expected return, divided by the standard deviation. He noted that if PRIT's consultant is overestimating the return, or underestimating risk, it would be possible to inflate the ratio.

Ghazarian stated that he has reviewed the history of searches performed by Segal. Over the last ten years, Segal has performed 14 searches. In the next 30 months, Segal will have to perform between 10 and 12 searches. The Chairman stated that is was the option of the Board's Attorney that this amendment would constitute a material change, and that the Board could not agree to it without issuing an RFP. Ghazarian stated that he is prepared to continue the relationship should the Board opt not to accept the proposed contract amendment, and that he looks forward to continuing to work with Cambridge. He stated that he feels that Cambridge has shown strong returns investing independently, and that he feels they can continue to do so in the future.

Ghazarian stated that he was not aware of any proposals to streamline the RFP process for favored managers.

The Chairman stated that it appears that gifts awarded to retiring employees can be considered as a legitimate expenditure. The Director stated that she purchased a chair for Brad Tenney upon his retirement. Motion by Gardner, seconded by Monagle to authorize the system to pay the cost of the chair. Voted unanimously.

Monagle moved to adjourn at 12:55 PM.